

The Psychology of Fraud

Why Good People Do Bad Things

Estate Planning Council of the Fun Coast

The Psychology of Fraud

**Why Good People Do Bad Things
What You Can Do About It**

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Oh, No! Not Another PowerPoint



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Frank J Navran

- **17 years (post-military and university)**
 - Corporate Manager, Trainer and Internal Consultant
- **12 years**
 - Navran Associates - Ethics, Leadership, Customer Care
- **8 years**
 - Ethics Resource Center - Director, Advisory Svcs
- **Past 7 years**
 - Navran Associates (semi-retired)
- **Relevant experience includes**
 - >200 client organizations in 20 countries
 - Trained/Certified >150 ECOs in UAE, Turkey and South Africa
 - 5 Books, >200 articles

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Context Data From 2009 NBES

- **National Business Ethics Survey**
- **Biennial survey of Corporate Ethics**
- **Research Report from ERC**
 - Pat Harned, PhD, President
 - Michael Oxley, Chair, BoD
 - Sixth in a series, begun in 1994
 - Details available at www.ethics.org
- **Companion NNEs and NGES also available**

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The Problem

- **49% of 2009 NBES respondents report observing misconduct on the job**
 - Common forms of fraudulent behavior reported included: lying to employees, lying to external stakeholders, benefits violations, falsifying time and/or expenses, document alteration, misrepresenting financial records, bribing public officials and insider trading
- **36% of those chose not to report what they observed to their management**
- **Of the 64% who reported what they observed 15% reported experiencing retaliation**

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Assumption

- **Given that organizations have formal systems to "prevent and detect" fraudulent conduct, we can assume...**
 - **Fraudulent conduct among individuals (where formal systems are lacking) are at best "as likely", and at worst "more likely", to commit fraud**
 - **Clients fall into the latter category**

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The Psychology of Fraud

Why Good People Do Bad Things

What We Can Do Today

- We will examine why good people do bad things - including:
 - The necessary preconditions for an individual to commit a fraud
 - How you (and the others within your organization) can mitigate those factors
 - How to create a functioning business culture that is "fraud resistant"

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The Navran Associates Case

- I will, use my own organization as an example throughout
 - Small business
 - Typically function as a solo practitioner
 - Extensive reliance on "associates" versus full-time staff
 - Serve a diverse client base

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Overview

- Defining our terms
- Exploring the psychology of fraud
- Understanding our vulnerabilities
- How to "fraud proof" your organization
 - Internal focus - organizational culture
 - External focus - minimize client fraud
- Taking the next steps
- Discussion is welcome on an ongoing basis

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Fraud

- In the broadest sense, a *fraud** is a deception made for personal gain
- The specific legal definition of fraud varies by legal jurisdiction (as do punishments)
- Fraud is a crime and is also a civil law violation
 - In criminal law, fraud is the crime or offense of deliberately deceiving another in order to damage them - usually, to obtain property or services unjustly - and can be accomplished through the aid of forged objects
 - In the criminal law of common law jurisdictions it may be called "theft by deception," "larceny by trick," "larceny by fraud and deception" or something similar
- Not every fraud is a criminal act

*per Wikipedia
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Freud

- In Freud's structural model of the psyche...
- The *ID* (inner desire) is responsible for our basic drives
 - It is amoral (not governed by external values), egocentric and ruled by the pleasure-pain principle
 - The id is illogical and will not take "no" for an answer "If it feels good, do it."

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Freud

- The *SUPER-EGO* acts as the conscience, maintaining our sense of morality and proscription from taboos

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Why Good People Do Bad Things

Freud

- The **EGO** balances between primitive drives and reality
 - Its *defense mechanisms* are often used when ID behavior conflicts with reality and either society's morals, norms, and taboos or the individual's expectations as a result of the internalization of these morals, norms, and their taboos
- One defense is to find “justifications” (rationales) for doing what we know is wrong

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Combining Freud And Fraud

- **Juxtapose Freud and Fraud and we get**
 - **Fraud is the fulfilling of an inner (personal) desire through the use of a deception in a manner that violates societal morals, norms or taboos**
 - **Fraud is different from other forms of misconduct in that it relies on trickery or deception (often, including “self-deception” by the “ego”)**
- **Thus, we find ways to give ourselves permission to do what we know is wrong because it produce a result we want**

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Getting Personal

- **Hypothetically...**
 - **What might motivate an Estate Planner to commit fraud?**
 - **I'll start... hard economic times**
 - **What might that fraud look like?**
 -

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Continuing To Get Personal

- **Hypothetically...**
 - **What might motivate a client to commit fraud?**
 - **I'll start... hard economic times**
 - **What might that fraud look like?**
 -

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Feeding The Hog Self-deception by the Ego

- **Lumber mill**
 - **Profits declining**
 - **Other measurements are constant**
 - **Consultant brought in to find out where the money is going**
- **Employees “Feed The Hog”**
- **Entitlement**

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Feeding The Hog

- **Defensive and retaliatory**
- **It describes how people who feel powerless**
 - **Find ways to protect themselves against the powerful**
 - **Find ways to punish the powerful for how they are being treated**
- **FTH is not limited to “employees”**
 - **Clients often resort to these same types of rationalizations to justify their actions**

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Why Good People Do Bad Things

Examples Of FTH

- **Two of my personal favorites**
 - **Malicious obedience**
 - Doing exactly what one is directed to do v. what actually needs to be done
 - **Selective Incompetence**
 - Choosing to "under perform"
- **How might an Estate Planner Feed the Hog?**
- **How might one of your clients do so?**

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Silent Sabotage

Self-deception by the Ego

- **Self-defensive in nature**
 - **People who feel threatened find ways to protect themselves from what they consider a hostile environment**
 - **People who feel powerless find ways to protect themselves from the powerful**
 - **And if, in the process, it hurts the powerful, that is a bonus!**

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Silent Sabotage

Scapegoating
Abdicating
Budget games
Over promising
Turf guarding
Emperoritis
Under delivering
Risk avoiding
Sharp penciling

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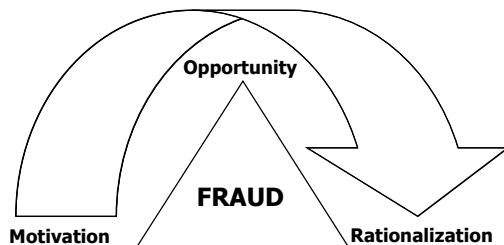
Today's Environment Is More Hostile

- **Some common perceptions that feed that hostility**
 - **Uncertainty/Distrust is higher today**
 - **We cannot trust the assumptions and/or institutions that we trusted before**
 - **Stakes are higher today**
 - **The price of failure is greater than ever**
 - **Competition is "stiffer" today**
 - **And some competitors do not share our commitment to high ethical standards**

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The Fraud Triangle



*Var Dr. Donald Cressey

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Defining Our Terms

- **Motive**
 - **The moving force or drive to act in a specific fashion or towards a specific goal**
- **Opportunity**
 - **The presence of circumstances that are conducive to and/or consistent with the necessary action being considered**
- **Rationalization**
 - **Lies we tell ourselves to give us permission to do what we know is wrong**

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Why Good People Do Bad Things

Motivation

- **What might motivate a "good" person to commit fraud?**
 - **Fear**
 - **If I don't do X something bad will happen to me**
 - **Entitlement**
 - **I deserve X because of ...**
 - **Anger**
 - **I am angry, and since I cannot express it directly I will do X**
 - **Perceived need**
 - **X is the only way I can meet some need/want**
 - **Temptation**
 - **I don't need X - but I want it and I can get it if...**

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Opportunity

- **Opportunity often is accompanied by:**
 - **Need/Desire**
 - I want the expected outcome/result/benefit
 - **Lack of proscription/barriers**
 - There is no specific rule prohibiting it and/or it can be done without significant difficulty
 - **Lack of perceived consequences**
 - Even if I am caught, nothing bad will happen
 - **Overconfidence**
 - I believe I can get away with this (even if a "lesser" person could not)

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Rationalization

- **Lies we tell ourselves to give us permission to do what we know is wrong**
- **Classics:**
 - No one will get hurt (No harm - no foul)
 - If I don't someone else will
 - Everybody else does it
 - I'm entitled because of how I was treated (FTH)
 - I have no choice
 - It's worth the risk - nothing bad will happen to me

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My Hero

- **New CFO in 2005 - We met October, 2008**
- **How's it going?**
 - **Better than most**
- **Tell me more**
 - **2006 - 1st meeting with her direct reports**
 - **Investments in AAA-rated "securitized debt"**
 - **Portfolio manager cannot defend other than in term of ROI and AAA rating**
 - **She charges him to develop a better reply**
 - **When he cannot, she gives him 6 months to divest anything he cannot adequately explain and defend**

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Shaping the Culture

- **What she did was to reshape the culture of an entire organization**
 - **I can't stand before my Board and defend our strategy on "I don't understand it, but everybody else is doing it and we're making a ton of money"**
- **It starts with "The Culture Question"**
 - **"If I were a new employee, and you wanted to help me succeed, what one thing would you tell me that I need to know to succeed here, but won't find written down anywhere?"**
 - **Asked thousands, over 20+ years**
 - **Never a "non-answer"**

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Controlling the Factors

- **Leadership can do a certain amount to prevent fraud**
- **Reduce Opportunity**
 - Proscribe - rules, policies and procedures
 - Make consequences consistent, significant and visible
- **Remove Motive**
 - Balance workplace fear of failure with preparation for success
 - Address workforce anger
 - Remove unnecessary temptations
- **But leadership alone cannot keep a person intent on committing fraud from doing so**

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Why Good People Do Bad Things

Fraud Prevention

- ❑ **How do we address the work environment to minimize fraud?**
 - ❑ **Environment**
 - ❑ Culture - The shared understanding of "How Things Really Work Around Here"
 - ❑ Policies and procedures - formal
 - ❑ Leadership behavior - informal
 - ❑ **Motivation**
 - ❑ Attention to tangibles - measures and rewards
 - ❑ Attention to intangibles - fairness, culture of respect
 - ❑ **Rationalization**
 - ❑ Open discussion of shared values
 - ❑ Preemptive versus reactive

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Ethical Culture

- ❑ **We use the phrase "ethical culture" to describe an organizational culture that is based on a set of ethical values or principles, such as***
 - ❑ Integrity
 - ❑ Objectivity
 - ❑ Competence
 - ❑ Fairness
 - ❑ Confidentiality
 - ❑ Professionalism
 - ❑ Diligence

*Certified Financial Planner Board of Standards Inc.

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Shaping and Sustaining an Ethical Culture

- ❑ **Stated position**
- ❑ **Formal systems**
- ❑ **Informal systems**
- ❑ **Measures and rewards**
- ❑ **Communication and education**
- ❑ **Reaction to critical events**
- ❑ **Leadership's perceived motives**

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The Key

- ❑ **The key is not to shift your focus away from Legal and Regulatory Compliance**
- ❑ **Rather it is to BUILD ON compliance by INCREASING the attention given the integration of values into routine decision making - if your goal is to build/sustain an ethical culture**

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Ethical Maturity

Individual Maturity

Self Actualization
Society
Peers
Authority

Organizational Maturity

Organizational Actualization
Social Responsibility
Best Practices
Compliance



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Midsize Companies and Larger

- ❑ **Leadership focus on ethical culture**
- ❑ **Formal values statement**
- ❑ **Code of ethics**
- ❑ **Ethics training**
- ❑ **Supporting systems**
 - ❑ Measurements
 - ❑ Rewards
 - ❑ Ethics reporting mechanisms
 - ❑ Published results

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Why Good People Do Bad Things

You Manage What You Value

- **E.g. Navran Associates**
 - Value customer satisfaction
 - To ensure we stay focused we unilaterally impose a money back guarantee
 - One "dissatisfied" customer out of >300
 - Once I was dissatisfied and imposed a refund
- **If you want something, then measure it**
 - Customer satisfaction
 - Follow-up - did you get what you needed?
 - Repeat business (90% over 25 years)
 - Referrals (that's how I got this engagement)
 - Objective success measures

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Estate Planning Professionals

- **Discussion Questions**
 - What values are explicitly applicable to how you run your organization/function?
 - What values are explicitly applicable to how you deal with your clients?
 - What characteristics do you explicitly try to integrate into your organization's culture?
 - How well is that working and how do you know?

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Estate Planning Professionals

- **You need to critically examine your organization and identify...**
 - What aspects of your organizational culture might create the *opportunity* for fraud?
 - What aspects of the current organizational culture might *motivate* you or an employee to commit a fraud?
 - What *rationalizations* might you or an employee use to justify the fraud?
 - What obligations do you have to address those findings?

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But... You Can't Stop There

- **You need to critically examine your clients...**
 - Their motivations and needs
 - The values they impose on the planning process
 - What might *motivate* them to commit a fraud or to encourage you to do so in their behalf?
 - *Rationalizations* might they employ to justify committing or encouraging fraud?
 - What obligations do you have?

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Mushroom Management

- **Mushroom Management - treating employees (and clients) like one would grow mushrooms**
 - Keep them in the dark
 - Feed the a bunch of "fertilizer"
- **Step one**
 - Shine more light on the subject
- **The ethics conversation must be had**
 - And you have to initiate it

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Good Data Contributes To Good Decisions

- **May need to do some data mining**
 - Professional practices typically collect and track critical data
 - Activity levels, call volume, success rates, remedial actions, disciplinary actions...
 - It can be useful to reexamine your historical data to identify what your case history says about your values and your fidelity to those values

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You May Need New Data

- **You may need to routinely gather new information**
 - **Employee satisfaction data**
 - **Client satisfaction data**
 - **Reasons for "lost employees"**
 - **Reasons for "lost clients"**
 - **Professional reputation (field/practice)**
 - **Client repute**

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How You Train

- **If you train your employees on professional ethics consider your strategy**
 - **Is professional ethics a "universal" subject - or is it for "professionals" only?**
 - **Are all employees fully engaged in maintaining "professional" ethical standards?**
- **How is training administered?**
 - **Individual coaching, counseling and feedback?**
 - **"Flea dip" or PPP or fully integrated into every aspect of work?**
 - **Significant experience or "check the box"?**

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What You Train

- **How much of your employee training is about**
 - **Compliance**
 - **Policies, procedures, rules, systems, processes...**
 - **Client service**
 - **Including when/how to say "No"**
 - **Ethics**
 - **Values, principles, reasoning?**

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Who You Train

- **Rank and File Employees**
- **Managers and Supervisors**
- **Executives and Officers**
- **Boards**
- **Shareholders**
- **Vendors and Suppliers**
- **Clients**

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Where You Aim

- **Compliance**
- **Best Practices**
- **Social Responsibility**
- **Actualization**

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Clients I Have Fired

- **I suspect we have all fired clients**
 - **Typically, I reserve that for clients who are being less than honest with me and/or expect me to be less than honest with others**

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Why Good People Do Bad Things

Clients You Have Fired

- Under what circumstances have you "fired" (or might you fire) a client?
- Under what circumstances might/ought you fire an employee?
- What rationalizations (lies) might you use to keep from firing a client/employee that needs firing?

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Challenge

- Given this discussion
 - What are you going to do in the next 30 days to address the fraud that might currently exist in your organization or within your client base?
 - How are you going to use this information to help you address the fraud motivators that may be present - thereby preventing further fraud?
 - What "excuses" might you use to do nothing different?

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Recap

- Fraud is a real problem
- We explored some of why that is the case
- We also considered what each of us can do to prevent and/or address fraud
- What is left is an opportunity for us to address any questions, issues or concerns that you might still have

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QAD

Thank You

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